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PACIFIC  **TELESIS**
Group-Washington

EX PARTE OR LATE FILED

October 8, 1996

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RECEIVED
OCT - 8 1996
Federal Communications Commission
Office of Secretary

Dear Mr. Caton:

Re: CC Docket No. 96-45 - Universal Service

On October 7 and 8, Rex Mitchell and Lee Bauman of Pacific Bell, Jay Bennett and I met with Dan Gonzalez of Commissioner Chong's office, John Nakahata of the Chairman's office, Jim Casserly of Commissioner Ness' office, as well as Jeanine Poltranieri, Anna Gomez and Brian Clopton of the Universal Service Branch, to discuss the above docket, specifically as set forth in the attached document. Please associate this material with the above-referenced docket.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Alan Ciamporcero

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List A B C D E

Competition, Interconnection and the Universal Service Imperative

Presented by Pacific Bell

October 1996

Primary Concerns with the FCC Interconnection Order

- **The Order gives tremendous advantages to CLECs and IXC's based upon current subsidies implicit in LEC prices**
 - Proxy prices for interconnection and unbundled elements are set extremely low
 - *The difference between our current revenues at today's prices and revenues using proxy costs reveals a "gap" of about 40%*
 - The opportunity to choose "rebundling" or resale on a customer-to-customer basis enables CLECs and IXC's to "strip" the subsidy, while the subsidy requirement remains¹
 - LECs are relegated to "wholesale" status with no means to respond to competition against retailers using LEC facilities
 - *If we lower our retail prices to our customers, then we automatically lower resale prices to non-facilities based CLECs*
 - *If we achieve cost reductions, then the savings will be flowed through to lower unbundled element prices for non-facilities based CLECs*

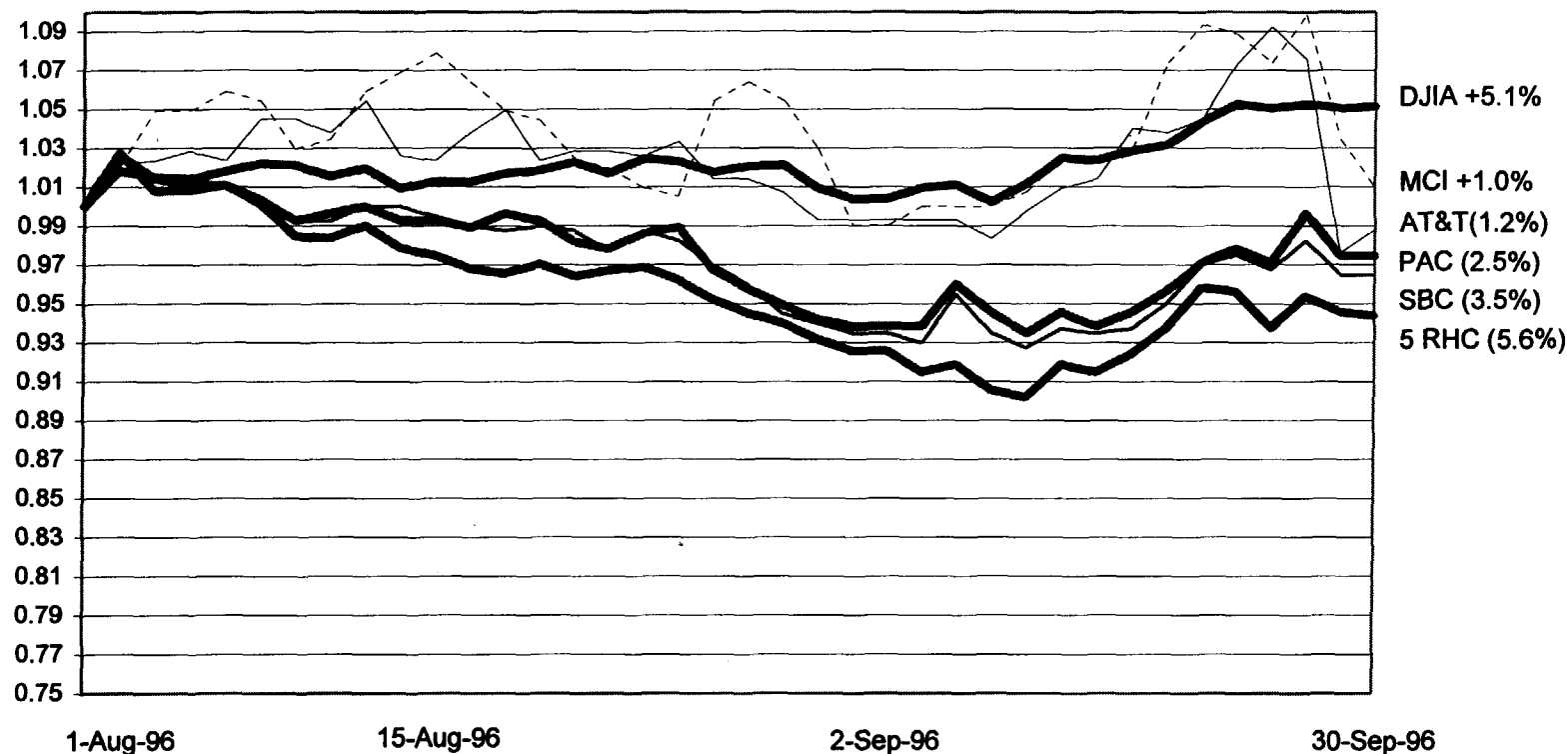
¹ Rebundling occurs when a CLEC or IXC creates a basic exchange service using the total combination of LEC unbundled elements.

Primary Concerns with the FCC Interconnection Order

- **The Order does not define a smooth transition to competition that benefits consumers and society**
 - Facilities based competition is *discouraged*
 - *Facilities based competitors now have unrealistically low prices that they must compete against, i.e., the wholesale prices of the LECs*
 - Investment in local networks and new technologies is *discouraged*
 - *Why should CLECs invest when cream skimming of our most profitable products and customers can occur without any investment?*
 - *CLECs and IXC's can choose resale for subsidized customers and rebundling for subsidizing customers*
 - States will face increasing pressures to raise residence basic service prices
 - *The extremely low prices for unbundled elements and resale further exacerbates the existing subsidy problem for state commissions*

Impact of FCC Interconnection Order

Relative Price Performance - August 1 - September 30



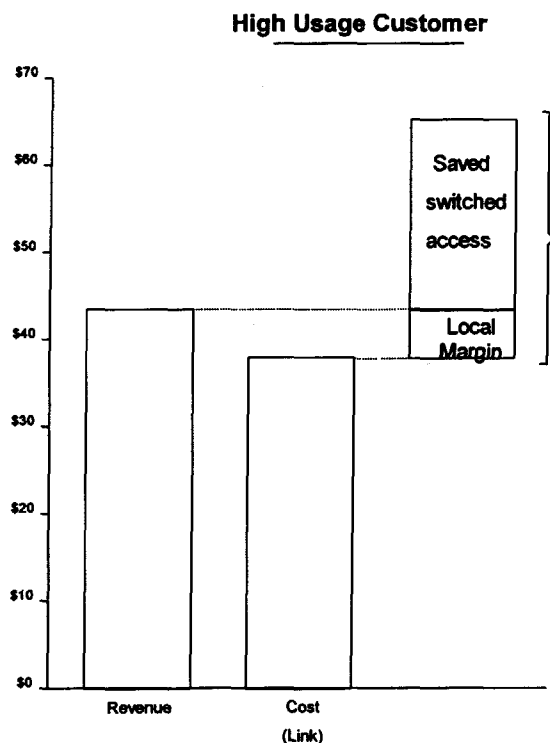
- Although the long distance stocks responded favorably immediately following the FCC's press release on interconnection, the negative impact on the RHCs began following the release of the full order on August 8th.
- The RHCs began to gain back ground following the announcement on Sept. 6th that four RHCs would appeal the FCC order. The strong performance may also be attributable to an easing of concerns related to an interest rate increase.
- Between August 1st and September 18th, the RHCs lost 6.3% compared to gains of 5% on the Dow and 9.2% at AT&T and 7.4% at MCI.

The Order Creates Significant Profit Opportunity for CLECs in California at the Expense of Universal Service

- CLECs can profitably serve all of our customers by choosing to buy unbundled elements (at cost-based prices) or resale services (at discounts off of our retail prices -- even prices that are currently subsidized)
- For the CLECs, every customer is a winner
 - High usage customers
 - Buy unbundled links and use own switch
 - Take full advantage of the subsidy currently contributed by these customers
 - Average usage customers
 - Buy unbundled links and LEC's switch (e.g., rebundling)
 - Take full advantage of the subsidy currently contributed by these customers
 - Low usage customers
 - Buy LEC's resale services
 - Leave the subsidy requirement with the LEC
- There is no reduction in the existing subsidies needed while there is a loss of existing subsidy support

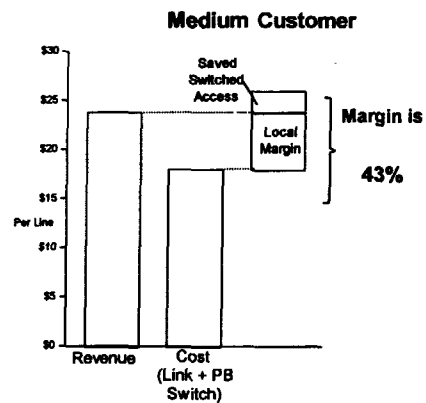
CLEC's Can Profitably Serve All Customer Segments Through Resale, Unbundling, and Rebundling

CLEC Margin (per line per month) is positive even for low usage residence lines which are unprofitable for Pacific Bell.



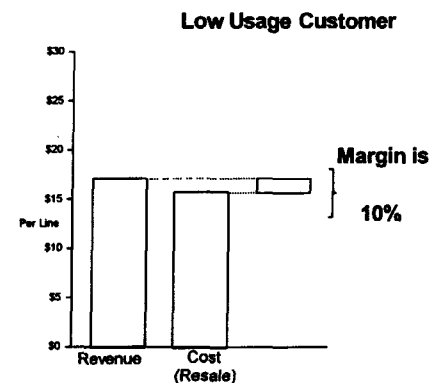
Margin is \$30/line

70%



Margin is

43%



Margin is

10%

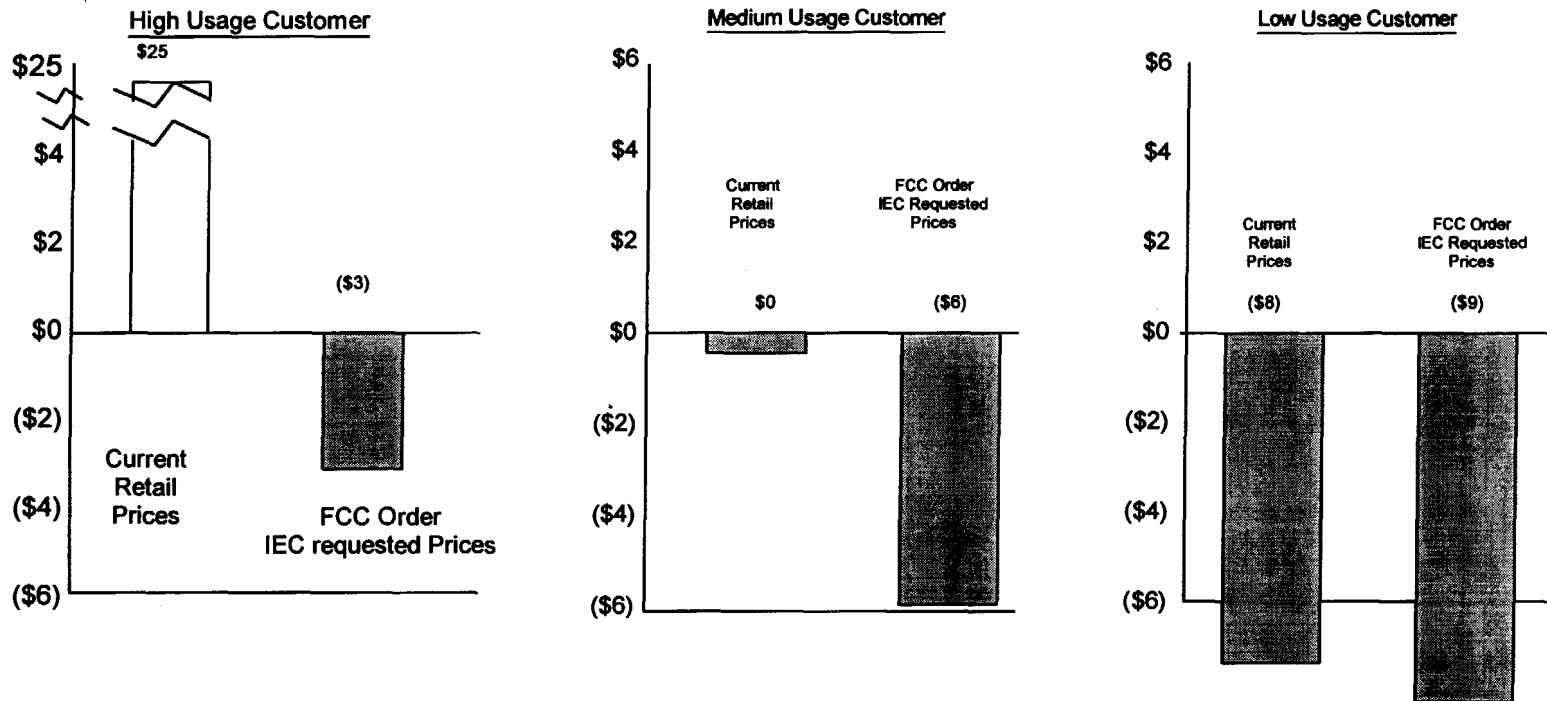
Large IEC's proposed prices are used for this illustration.

Impact on Pacific Bell Earnings in the Consumer Market

Result: Pacific loses contribution for every line sold to CLECs

Cream-skimming heightens the effect of share loss in the consumer market.

Pacific Bell Margin per month for one line

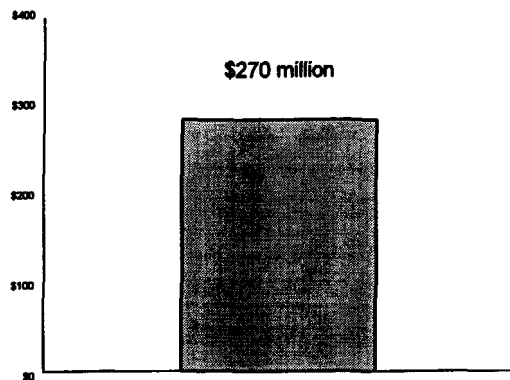


Because of tremendous incentives for CLECs to attack high usage customers, Pacific will lose the customers who provide margins to pay for Universal Service. The CLECs may retain positive margins because they may provide minimal support of Universal Service.

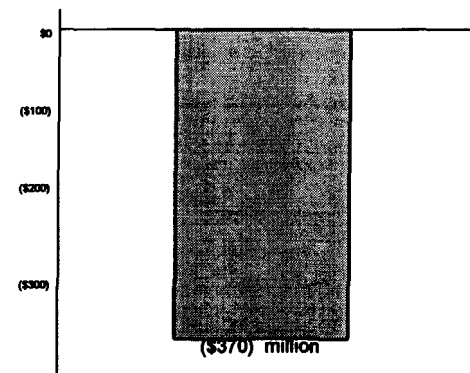
The Interconnection Order Enables IXC's to INCREASE Profits While Dramatically Reducing Pacific Bell's Profits

- Pacific will implement prices and terms which meet the FCC Order requirements even though Pacific has filed an appeal of that Order

**Estimated AT&T Pre-Tax Annual Margin
from Residence Local Services in Calif. with 96-98 Order**



**Pacific Bell Annual Loss of Pre-Tax Earnings
due to Local Competition in Residence Market Only**

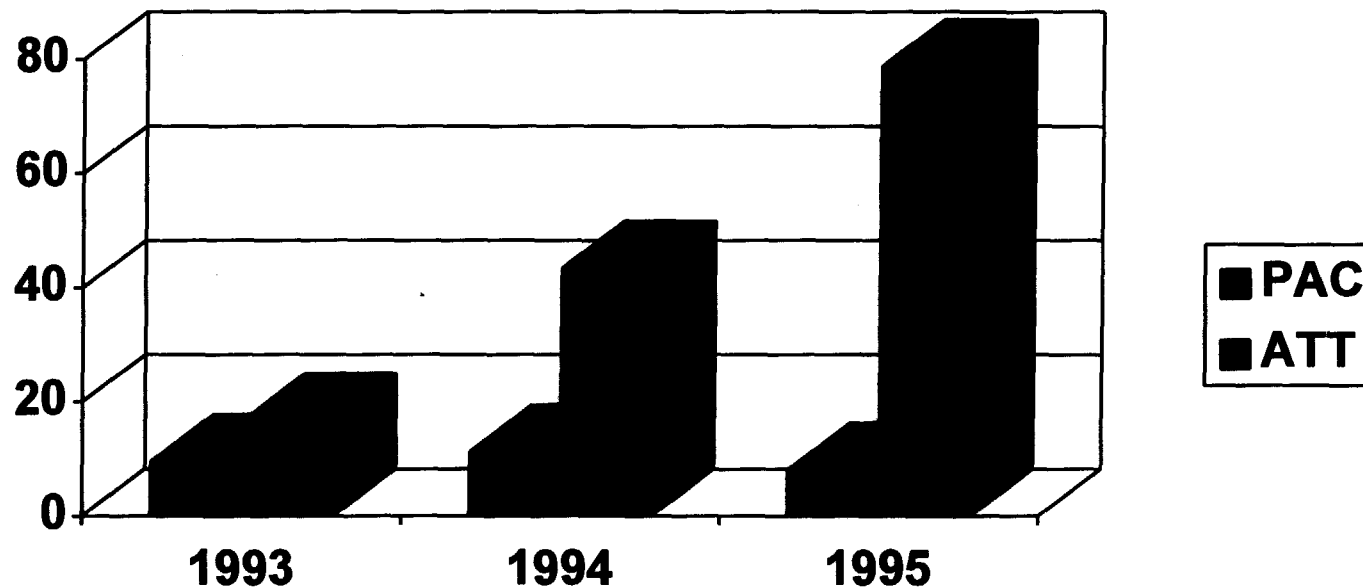


AT&T's proposed prices are used for this illustration.
Annual estimates by end of 1998 w/o switched access restructure impact.

The IXC's Do Not Need Financial Assistance From Regulators

Intrastate Earnings - California

% Rate of Return



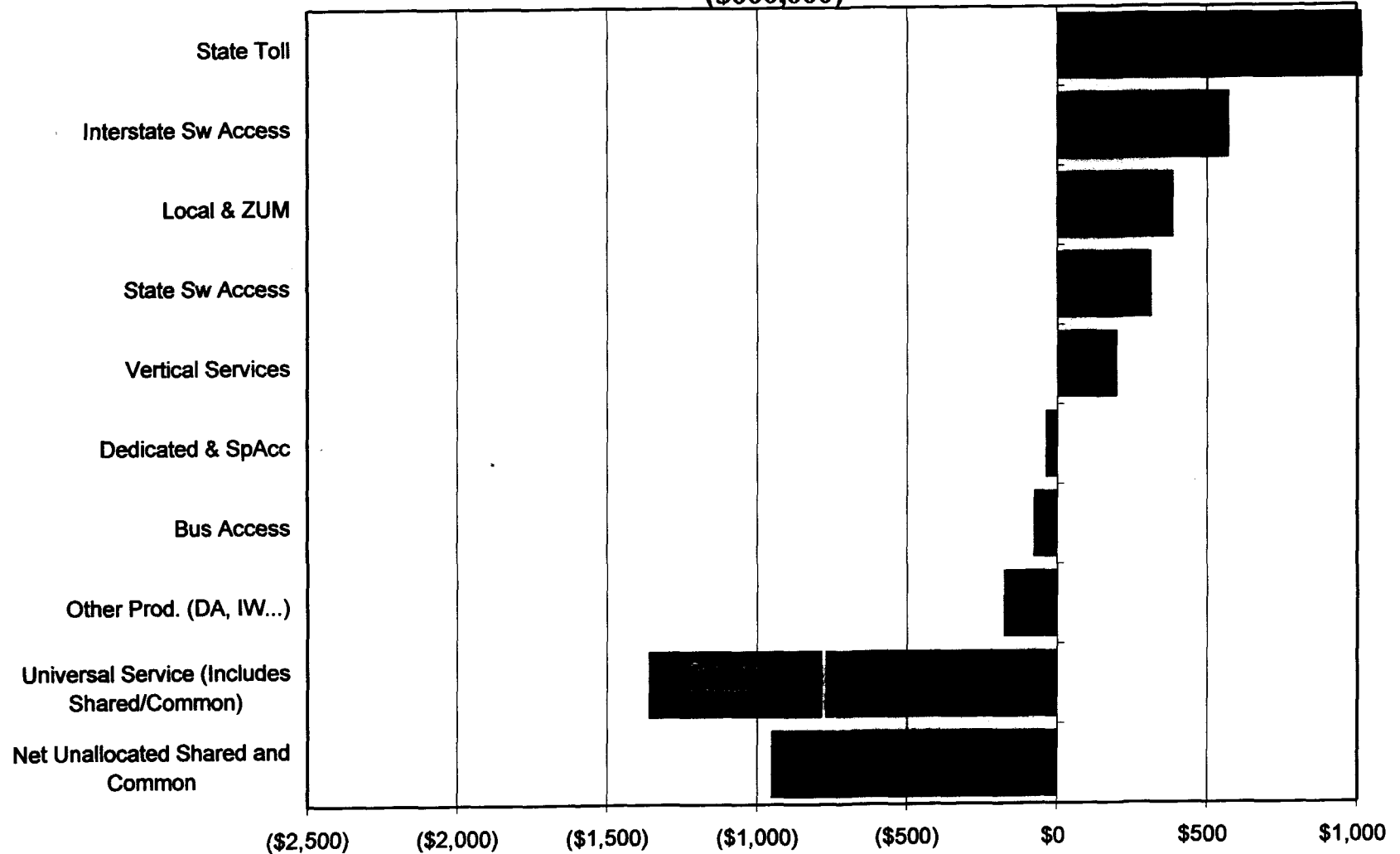
- Pacific's reductions in switched access prices have dramatically increased AT&T's earnings
- To date, IXCs have not shown a propensity to flow through LEC price reductions to their customers

Implications of FCC Interconnection Order on Universal Service and Access Reform

- **Order makes universal service and access reform an immediate imperative**
 - Results in loss of implicit and explicit subsidies that now support universal service
 - *Turns the \$1.3 billion subsidy in Pacific's prices today into pure profit opportunity for the CLCs, but the subsidy need does not disappear*
 - *Destroys access charge structure as we know it today, and explicit support for universal service, but the subsidy need does not disappear*

Pacific Bell - 1995 Product to Product Subsidy

(\$000,000)



Key Elements of a Universal Service Subsidy Solution

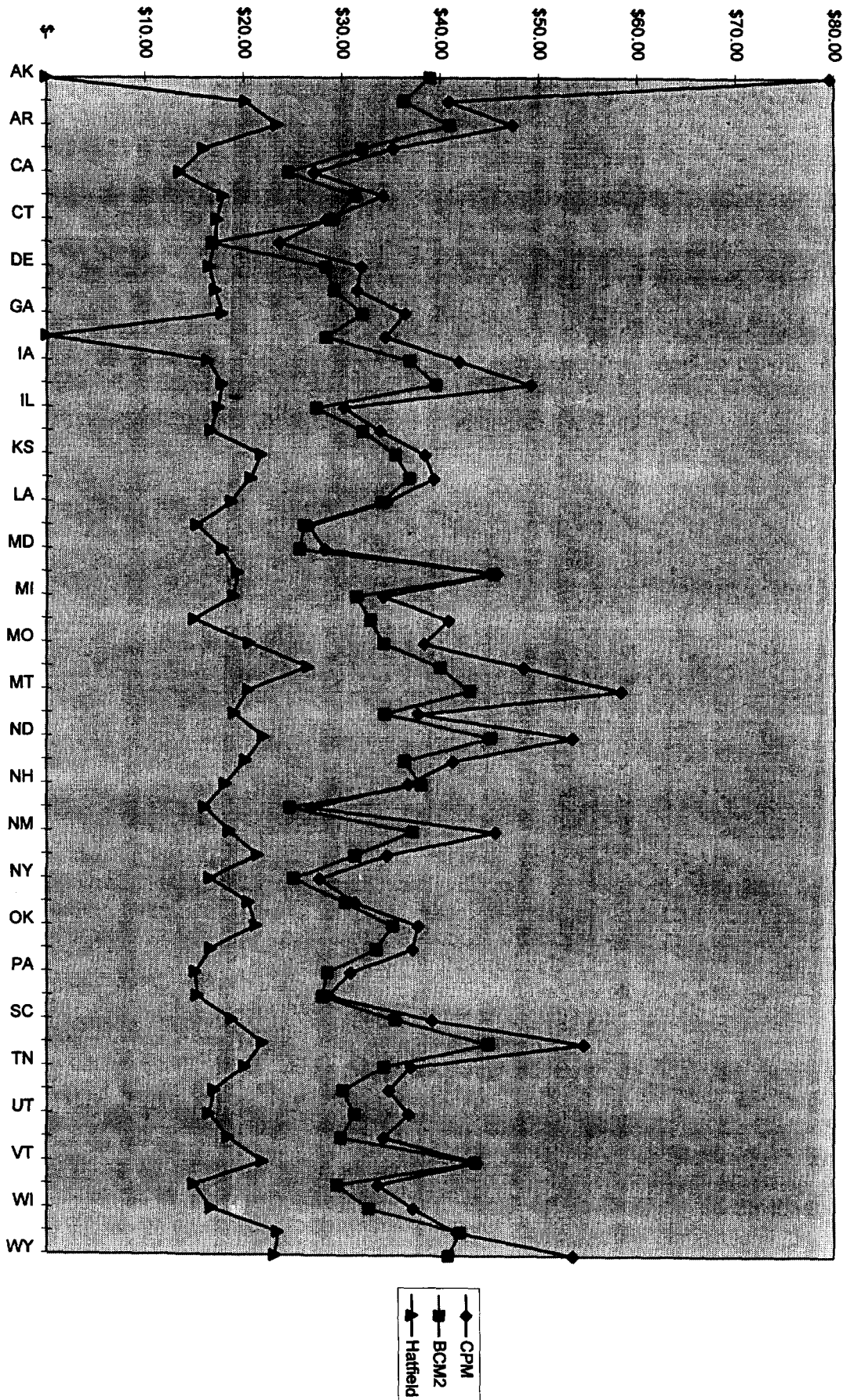
- Sizing a new Universal Service Fund
- Determining the scope of the geographic area to be targeted
- Setting a benchmark price
- Linking subsidy to an unbundled, resale environment
- Addressing jurisdictional issues
- Focusing on the needs of the educational community

Universal Service Subsidy Must Be Appropriately Sized

- **The Telecommunications Act of 1996 requires a “specific, predictable and sufficient” mechanism to fund subsidy**
 - An undersized fund will not eliminate subsidies implicit in current prices; the market will thereafter eliminate the subsidies through a combination of resale and rebundling -- subsidies would not be available to universal service
 - An undersized fund will discourage investment -- companies will not invest in facilities if they cannot expect to realize a profit from them

| | Assume Hatfield Estimates are Correct | Assume BCM2/CPM Estimates are Correct |
|-----------------------------------|--|---|
| Hatfield Estimates Prevail | OK | <ul style="list-style-type: none"> • Under investment • Intense resale and rebundling competition • Hundreds of businesses spring up -- all dependent on arbitrage • Difficult to increase prices later (e.g., ESP exemption) |
| BCM2/CPM Estimates Prevail | <ul style="list-style-type: none"> • Over investment • Intense facilities based competition • Competition develops more slowly • Easy to lower prices later to correct | OK |

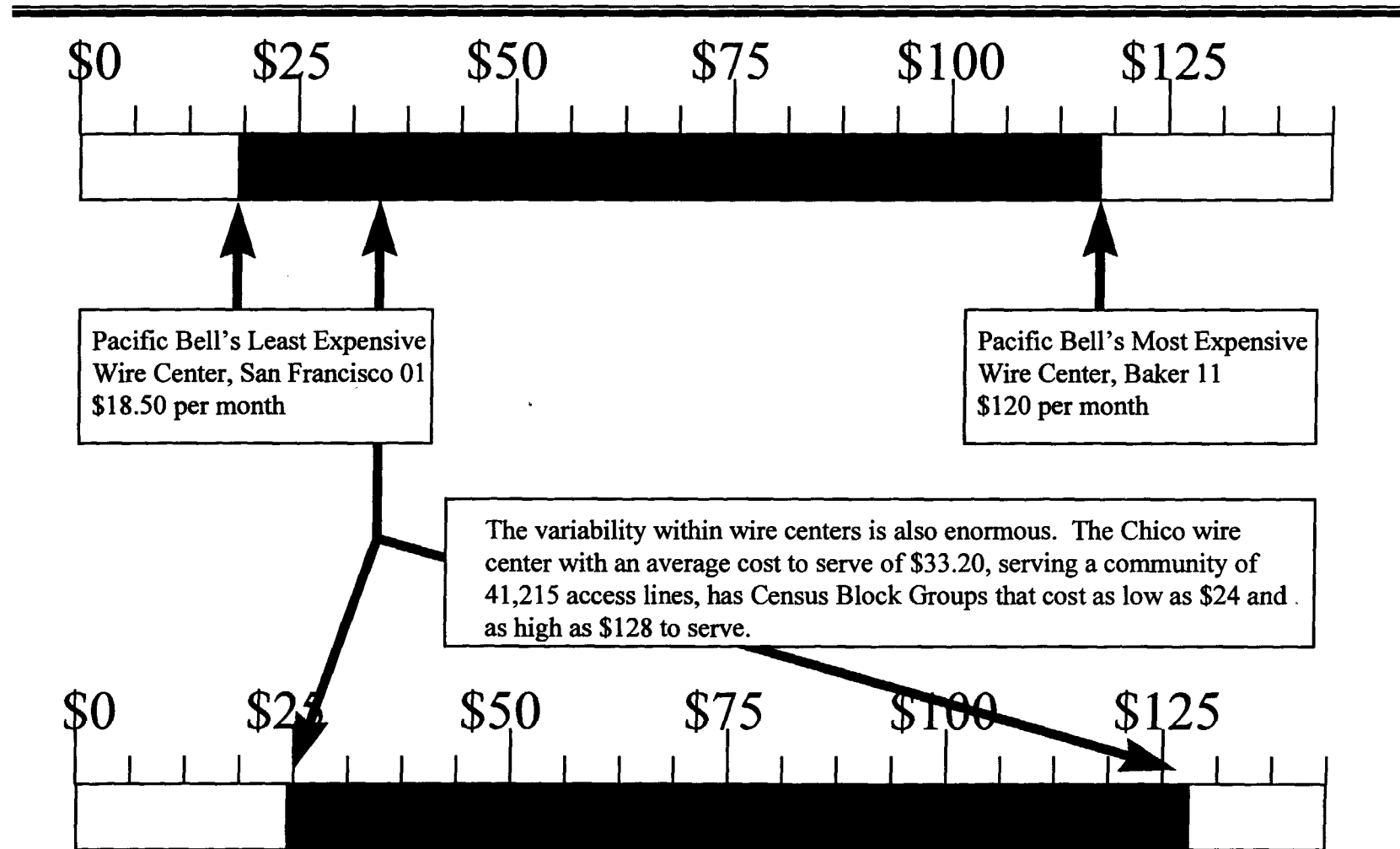
50 State Comparison of Models



Universal Service Subsidy Must Be Appropriately Targeted

- Current system targets study area (state)
 - By averaging across a large geographic area, carriers who serve states with mix of high cost and low cost areas are penalized
- Subsidy dollars must be narrowly targeted to prevent cream-skimming
 - Subsidy support should be determined on the basis of the smallest practical geographic unit (e.g., census block group)

There is Extreme Variation in the Cost of Basic Exchange Service Which Must be Recognized in any Universal Service Solution



A Benchmark Price

- FCC must set just, reasonable and affordable rates
- Affordability must be targeted below the state level so that low income areas are not penalized for being in the same state with high income areas
- A national or statewide benchmark obscures the wide variation in rates and income levels
- Target benchmark to county income level
 - A county median income benchmark (0.7%) addresses the income disparities between urban and rural

| State | Low Income County | High Income County |
|--------------|-------------------|--------------------|
| California | \$20,500 | \$48,000 |
| Missouri | \$13,800 | \$40,300 |
| Washington | \$20,000 | \$36,100 |
| Florida | \$15,400 | \$35,600 |
| South Dakota | \$13,300 | \$28,500 |

Subsidy in an Unbundled, Resale Environment

- Subsidy dollars must flow to the entity incurring the cost but not recovering it
- For resale, subsidy must go to facilities based provider -- by definition, if retail price requires subsidy, discounted wholesale price requires the same subsidy
- For unbundled elements, subsidy must be apportioned between the facilities provider and the retail provider
 - The apportionment must take into account that unbundled element prices are geographically deaveraged into a small number of zones while universal service support must be targeted into smaller areas (e.g., census block group)
 - Apportionment can be accomplished through an appropriate model that disaggregates costs for link, switch, etc. on a geographic basis

Universal Service - Jurisdictional Issues

- FCC interconnection and pricing rules affect both jurisdictions
- Congress intended universal service provisions, whether established by state and/or federal regulators, to yield “just, reasonable and affordable” rates
- Jurisdictional split should be based upon a benchmark, not separations rules
 - Benchmark approach complies with the Act
 - FCC would fund costs above the benchmark
 - States can establish subsidy funding for the difference between the federal benchmark and the basic service price (if price is below the benchmark)
- Subsidy should be funded by a surcharge across all telecommunications services
 - States would apply a surcharge across all telecommunications services originating in the state
 - The FCC would apply a surcharge across all telecommunications services

Education Proposal

- Distribute funds directly to schools and libraries via credits. Providers redeem credits for cash from the fund.
- Allocate funds according to:
 - Threshold for all institutions
 - Incremental support based upon number of students
 - High cost, low income, technological impoverishment variables
- Carry annual allocations over year-to-year so institutions who are not ready do not lose support

Actions for Universal Service Joint Board

- Establish a fund large enough to address the impact of Interconnection decision
- Establish reasonable benchmark. Target benchmark to relatively small area (county).
- Determine costs above benchmark using either actual costs or accurate proxy model
- Distribute subsidy based on small geographic unit (census block group at the minimum) to avoid cream-skimming